Russia: Russian Banking Industry
Robust Growth in Retail Banking

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Summary

Russian banks continue to benefit from positive macroeconomic trends, the government's strong financial position, and the economy's high liquidity level. Results have included a growing level of financial intermediation, improving loan performance, and higher profits from commercial and investment banking services. Robust economic expansion and a boom in the Russian consumer sector have created opportunities for drastic growth in retail banking. According to recently published research by Alpha Bank, the total retail banking market reached $42 billion by the end of 2005, and by 2010 is expected to reach as high as $112 billion. Although viewed as a healthy trend indicative of a more mature stage of banking market development, concerns exist about how widespread the demand for retail banking services has become, and whether the banking sector has the capacity to effectively deal with the consumer sector's sudden growth in large cities across the country.

Market Demand For Retail Banking Services

The Russian economy has been growing for the last seven years (6.7% average per annum). During this period, it has expanded overall by 43.3%. In 2005, the economy grew by 6.4%, and GDP reached 21,665 billion rubles (roughly $774 billion). The mechanism for growth has been based on growth of consumer and investment demand under conditions of greater liquidity in the economy, and the outstripping growth of consumer demand over investment demand, particularly in 2005.

The growth of consumer demand is generated from significant increases in real disposable incomes and continued intensive consumer borrowing. According to the Central Bank of the Russian Federation (CBR), household borrowing increased by 77.3% in the first eleven months of 2005, reaching 1,093 billion rubles.

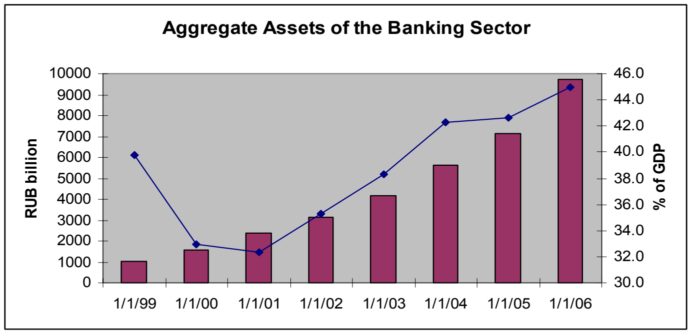
According to a November 2005 press release by BNP Paribas, internal demand should support Russia's continued economic momentum. The press release noted that "household spending is expected to be fed by increased real wages, rising consumer credit, and lower interest rates, in a stable macroeconomic and political environment. Additionally, as the world's second oil exporter, Russia should continue to benefit from favorable oil market conditions."

Analysts of a local bank-rating agency, RusRating, anticipated in October 2005 that retail loan volumes in Russian would continue to grow over the medium term. The market's potential is enormous. General public demand for credit resources still outstrips supply, which has led to high interest rates on short-term loans, in turn making this line of business highly attractive.

Retail lending in particular is expected to continue growing at a fast rate, supported by the above-mentioned macroeconomic trends. There is also continued space in the market to accommodate such growth: consumer loans currently equal less than 5.4% of the country's economy, compared with over 70% of gross domestic product in the United States and over 51% in Western Europe.

Market Data

Although the Russian banking system is still unable to fulfill the capital and credit needs of this rapidly growing market economy, the banking sector has rebounded impressively since the 1998 financial crisis. In 2005, the Russian banking sector grew faster than Russia's economy as a whole – and at a higher pace than the previous year.



As of January 1, 2006, the banking sector's aggregate assets totaled 9.75 trillion rubles ($338.7 billion), up 36.6% year-on-year compared to 27.4% in 2004. Aggregate retail deposits grew by a healthy 39.3% in 2005, reaching 2.75 trillion rubles ($95.8 billion) by January 1, 2006. The share of foreign currency deposits declined from 26.2% in 2004 to 24.4% in 2005, comprising a total value of 672.6 billion rubles ($23.4 billion).

Despite high rates of growth, the sector remains small relative to its international peers. Using the ratio of aggregate assets to GDP as an indicator of market penetration, Russia, with assets amounting to 45% of GDP as of January 1, 2006, lags behind most emerging economies (where ratios range from 50-100%) and is far behind most developed economies.

According to the latest Banking Strategy issued jointly by the CBR and the Government of Russia (GOR) in April 2005, by 2009 the goal is to raise the ratio of aggregate assets to GDP to 56-60%, the ratio of aggregate capital to GDP to 7-8%, and the ratio of aggregate loans to the real sector to GDP to 26-28%.

In recent years, the asset structure of Russian banks has shifted more heavily to loans, which now comprise over 60% of aggregate assets. In 2005, the total value of loans increased by 40%. Consumer loans posted the fastest growth at 95% year-on-year, with their share in the sector's total loan portfolio increasing from 13.3% in 2004 to 18.4% in 2005 (4% at the start of 2001). Retail loans to residents nearly doubled in 2005, rising from 618.9 billion rubles ($22.3 billion) in 2004 to 1.2 trillion rubles ($41 billion) in 2005. Alfa-Bank's analysts forecast that the total retail market will reach $112 billion by 2010.

It should be noted, though, that consumer credit in the last several years grew significantly faster than personal deposits, which threatens the balance of assets and liabilities and may negatively impact the financial stability of Russia's retail banks. Although the CBR reports that past-due retail loans make up only 2% of all loans within the sector, the top 200 banks carry a proportionally riskier loan portfolio, with bad loans comprising 3.6%. For example, residential retail loan delinquencies in 2005 doubled, from 8.4 billion rubles (US$303 million) in 2004 to 21.8 billion rubles (US$757 million) in 2005.

	Retail Loans, RUB bn	% GDP	% Assets	% Personal Incomes
1/1/1999	20.1	0.8	1.9	1.1
1/1/2000	27.6	0.6	1.7	1.0
1/1/2001	44.7	0.6	1.9	1.1
1/1/2002	94.7	1.1	3.0	1.8
1/1/2003	142.2	1.3	3.4	2.1
1/1/2004	299.7	2.3	5.4	3.4
1/1/2005	618.9	3.6	8.7	5.7
1/1/2006	1179.3	5.4	12.1	8.8

Source: CBR

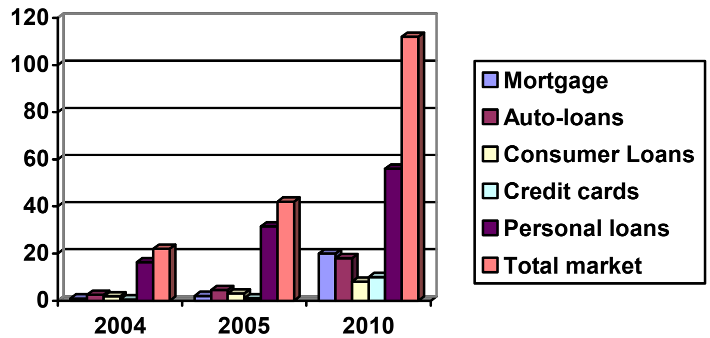
Recent publications concerning retail loans often presume that local banks underreport bad loans to the CBR. In an interview with RBC Daily, Yevgeniy Bernshtam, former senior Alfa Bank manager and current Chairman of the Board of Directors at Fosbourne Home and Sequoia Credit Consolidation, claimed that all banks in Russia involved in consumer lending carry at least 5% in bad loans – and those banks involved in “express” or point–of-sale credit carry closer to 10-15%.

Despite this trend, Russia’s lending market is still relatively small compared to its peers. Consumer loans currently equal less than 5.4% of the country's economy, compared with over 70% of gross domestic product in the United States and over 51% in Western Europe. Therefore, in the near-to-medium term, the risk of an Asian-style debt crisis seems to remain quite small.

Best Prospects

According to recently published Alfa-Bank’s overview of the Russian Retail banking market, personal loans provided by banks in cash account for 75% of the total loan portfolio.

However, the demand for more sophisticated banking products is growing, and the mortgages and credit cards markets are considered as the two most dynamic areas in today’s market.



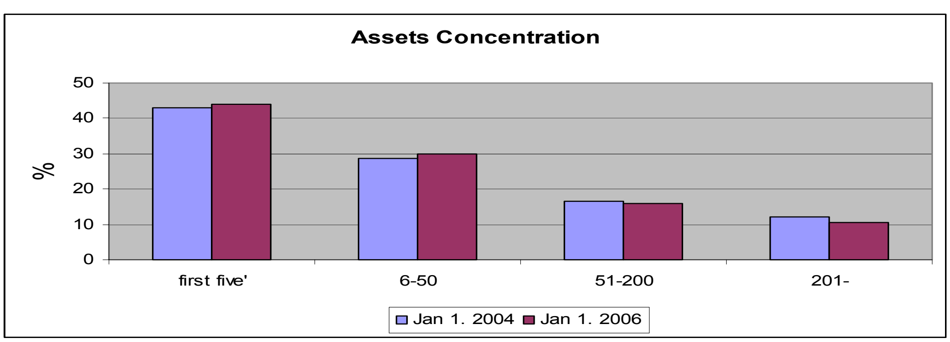
Sources: CBR, Alfa Bank estimates

The mortgage market is still very poorly developed, representing just 0.3% of GDP. However, it is expected to increase tenfold by 2010 to reach around $20 billion. Mortgage loan rates are expected to go down and loan terms to increase. Some banks even believe that the mortgage market could expand to as high as $40-60 billion by that time.

Retail lending, credit card business, car loans, mortgage banking and expansion to the regions will prove the most attractive segments of the banking sector. In the credit cards segment, Russia accounts for only 2.0 million credit cards, for which banks delivered $1 billion in loans.

Key Suppliers of Retail Banking Services

Several peculiarities characterize Russia’s banking sector. First, it is essentially a two-tier system, with the state-owned and/or state-supported banks dominating a highly fragmented private sector. Second, it is highly centralized geographically, with more than half of all credit institutions (646 of 1253, or 51.6%) based either in Moscow City or Moscow Oblast. Third, banking assets are also extremely concentrated. As of January 2006, Russia’s top 5 banks accounted for 43.8% of the sector’s aggregate assets; the top 50 banks – 73.8%; and the top 200 (out of over 1200 in total) – 89.6%.



Source: CBR

In addition, the sector is notoriously non-transparent; ownership is concentrated in the hands of a few, and foreign capital plays a relatively small role in the sector.

Recent mass media reports and publications have expressed concerns as to whether or not the banking sector in Russia has the capabilities to effectively deal with the growing demand caused by a buoyant spurt of the consumer sector in large cities of the country. S&P notes that, despite prospects for more dynamism in the Russian banking industry, the plodding pace of bank reform and the government's push to reinforce state banks' dominance are holding back improvement of private sector banks. Private sector banks, which usually play the role of the growth engine in a banking system, are still vulnerable to potential economic and political shocks in Russia.

State-owned or state-controlled banks, such as Sberbank (20,000 branches and $8.6 billion in capital) and Vneshtorgbank (more than 100 branches and $2.4 billion in capital) obviously have the prevailing market share, in terms of both ruble and foreign currency financing. Sberbank has the largest share on the retail market, controlling 45% of all retail loans. State banks will remain dominant, with perhaps a slight shift in retail market share from Sberbank to Vneshtorgbank likely. While the state may indeed divest itself of some smaller banks, it looks increasingly likely that one or two new state banks will emerge.

The largest private bank operating in this market is Rosbank with a 4.2% share. UralSib controls 2.3% of the market, Raiffeisen – 1.9% (expected to increase as Impexbank itself accounts for 1.2%), Bank of Moscow – 1.3%, and VTB – 1.2%. Ruble loans account for 85% of the retail market, while dollar-denominated loans account for only 15% (mainly used for mortgage and auto loans).

Consolidation in the sector will continue, spurred by pending legislative amendments that will require a minimum equity of 5 million euro from January 1, 2007. Banks that fail to meet this requirement will only be permitted to continue operating if their equity is maintained at the level attained as of January 1, 2007. We expect a wave of mergers and acquisitions to accompany this new law, with small banks at the greatest risk of either closing or being acquired.

While the level of foreign capital is relatively low, the presence of foreign capital in the sector is expanding according to several indicators. As of January 1, 2006 there were 40 banks in Russia with 100% foreign capital, eight incorporated with more than 50% foreign capital, and 136 licensed credit institutions reporting some foreign capital participation in their authorized capital.

The amount of foreign capital in the sector as a whole is growing, rising from 6.2% in early 2005 to 11.6% in 2006. Although CBR regulations prohibit foreign banks from establishing branches in Russia, the number – and size – of foreign subsidiaries is increasing. As of January 1, nine foreign-owned banks ranked among the top 50 largest Banks in Russia by assets. These include International Moscow Bank (8th), Raiffeisenbank (9th), Citibank (14th), ABN-Amro Bank (30th), Home Credit and Finance Bank (32nd), ING Bank (35th), Commerzbank (39th), Deutsche Bank (44th), and Bank Societé-Generale Vostok (46th). As for trustworthiness, Russian depositors are placing greater trust in foreign-owned banks: subsidiaries of foreign banks have shown the most rapid growth in retail funding.

Competition for Consumers

On the other hand, Russian banks are considered to be more flexible and able to offer more creative products, because they are more familiar with their clients' mentality. Popular banking products offered by Russian banks include cash lines of credit issued in 30 minutes or less, and shopping loans offered in retail stores.

Local banks can also compete by offering much higher deposit rates. For instance, Russian banks offer interest rates of 9-10% for fixed-term, one-year deposits of 100,000 rubles ($3,700), while foreign-owned banks usually offer only 3 – 4% percent for similar deposits. Of course, higher interest rates usually indicate higher levels of risk.

As for state-controlled banks, they can more easily lure deposits due to the perception among many Russians that they are safer, having state backing. On the other hand, the state-controlled banks have a continual and well-known problem with poor management.

The consumer credit market will continue to expand, with a likely increase in non-cash (i.e., credit card) payments and electronic "on-line" settlements. Sberbank is launching its national payments system, "Sbercard." If this project succeeds, Sberbank may regain an alternative edge in the retail market after losing some of its share of the household deposits market to VTB.

RusRatings notes that the sector is segmented into groups of banks that serve different clienteles with different needs. In turn, the competition among foreign banks, private banks, and state-controlled banks is not as vicious as it might be otherwise.

Market Entry

Despite pressure applied on the GOR to open the financial services markets, current legislation allows foreign banks only to operate Russian subsidiaries with branches that connect to the subsidiary, and not to the bank's headquarters abroad. However, many analysts do not consider this as a factor limiting competitive advantage or the strategy of foreign banks, which still manage to move capital into Russia through subordinated loans or new share issues, giving them a distinct advantage over local banks forced to accumulate deposits and retail loans bit-by-bit. Nevertheless, the home turf advantage of Russian banks sends a negative signal and keeps foreign counterparts at bay.

Typically, a foreign bank is the lender of choice for multinational companies in Russia, which often have a preexisting relationship with the bank in its home country. So far, most foreign banks have only limited consumer offerings. But private Russian banks have their own cozy relationships with certain Russian companies and usually offer retail banking to those companies' employees. And, of course, state-controlled banks similarly serve the needs of the government.

Nevertheless, due to the above-mentioned perception of the Russian population, the subsidiaries of foreign banks have shown the most rapid growth in retail funding. While it remains unclear whether foreign banks will be allowed to open branches in Russia, the market share of foreign subsidiaries as well as of non-resident minority shareholders of Russian banks is expected to rise.

Market Issues and Obstacles

Despite the abovementioned healthy trends indicative of a more mature stage of banking market development, it is important to note that the Russian banking industry remains substantially risky due to its limited ability to withstand external shocks. Factors that continue to negatively affect the industry include the lack of refinancing mechanisms, significant risk concentration, an inefficient legal system, weak regulation, and an undeveloped bank industry infrastructure.

Another factor that is commonly noted is the low disclosure levels of Russian banks, especially in comparison with international peers. Furthermore, transparency levels at Russian banks are lower than those of the largest Russian non-financial companies. According to Standard & Poor's analysts, the situation may improve if Russian regulators and participants in the capital markets apply more pressure to banks in order to increase transparency.

The results of Standard & Poor's "2005 Transparency and Disclosure Survey" showed that the biggest gaps in Russian banks' disclosure include the identity of beneficial owners and information about related-party transactions, corporate governance structure, and procedures such as risk management policies.

The current dismal disclosure practices of Russian banks are detrimental to fostering good relations with the investment community and the general public. The bank run in Summer 2004, when banks lost about 2% of retail deposits during several days in July, was a good example of how lack of trust and confidence could be damaging to banks.

Despite regulatory advancement in the past two years, a lack of political willingness to tackle major weaknesses in the banking sector prevails. The Central Bank of Russia missed an important opportunity to roll out radical reforms in the industry when it admitted several marginal banks in the first selection round for Russia's new retail deposit insurance system.

For More Information

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